

What's your Active Malfunction? Insured Denied Coverage for Contractual Claim of Poor Workmanship

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Every day sellers of goods and services negotiate with customers for sales contracts. What if a seller was not forthright with a customer during these contract negotiations and the product failed to meet the customer's expectations of good workmanship? And if that customer seeks legal redress, is the seller's insurance company obligated to indemnify and defend the seller during litigation? In Erie Insurance Exchange v. Abbott Furnace Company, 2009 PA Super 88, 2009 Pa. Super. LEXIS 107 (May 13, 2009), the Superior Court of Pennsylvania ruled that an insurance company is not obligated to defend or indemnify an insured for claims of poor workmanship.

Abbott Furnace Company ("Abbott") designs and manufactures annealing furnaces. Abbott purchased a general liability insurance policy from Erie Insurance Exchange ("Erie"). In 1999, Abbott began contract negotiations with Innovative Magnetics, Inc. ("IMI") to design and build furnaces for IMI's magnetic metallic laminations production. As these laminations are highly sensitive, IMI raised concerns with Abbott about the furnace's design. Namely, IMI told Abbott that the furnace was for a specific use, and therefore, IMI required a certain design for the furnace. Abbott assured IMI that they had built several similar furnaces for one of IMI's primary competitors and that the competitor had never experienced any problems with the furnace. IMI purchased the furnace from Abbott. The furnace, however, later turned out to be defective with respect to IMI's specific needs. IMI then discovered that the furnaces designed by Abbott for IMI's competitors also had the same defect.

IMI filed suit against Abbott, claiming that Abbott had a duty to apprise IMI of the furnace's design defects. Abbott settled with IMI and contacted Erie to request indemnification and defense. Erie denied their request, maintaining that none of IMI's claims triggered coverage. Specifically, Erie contended that coverage under its policy was only triggered in the event of an "occurrence." Because the only alleged damages claimed by IMI followed from an alleged breach of contract, no "occurrence" had been pled and, therefore, coverage was not triggered.

Erie filed a declaratory judgment action against Abbott and won a motion for summary judgment. The trial court relied on Kvaerner Metals v. Commercial Union Ins. Co., 589 Pa. 317, 908 A.2d 888 (2006), for the proposition that a third party's complaint alleging only faulty workmanship and damage to insured's work product does not trigger coverage under a standard commercial general liability policy. Abbott appealed, alleging that the furnace "actively malfunctioned" and damaged other IMI property, thereby triggering coverage.

The Superior Court reiterated that an insurer's duty under its policy is triggered by the language of the complaint against the insured and agreed with Abbott that provisions of a general liability policy provide coverage if the insured's work or product actively malfunctions and causes injury to an individual or damage to another's property. However, the court, following Kvaerner, stated that contractual claims of poor workmanship do *not* constitute the active malfunction needed to establish coverage under a general liability policy. Therefore, the court must look to the language of IMI's complaint to determine if IMI pleaded a negligence claim that Abbott's furnace actively malfunctioned.

In its review of IMI's complaint, the court relied on Pennsylvania's "gist of the action" doctrine. When a

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Plaintiff alleges that the defendant committed a tort in the course of carrying out a contractual agreement, Pennsylvania courts examine the claim and determine whether the "gist" of the claim is based in contract or tort. The important difference between a breach of contract claim and a breach of tort claim is that a contract claim arises out of "breaches of duties imposed by mutual consensus agreements between individuals" and a tort claim arises out of breaches of duties imposed by law as a matter of social policy.

While IMI did reference Abbott's negligence in their complaint, the gist of IMI's claim was that Abbott had a duty to inform IMI of the design defects experienced by IMI's competitor or, at least, had a duty to not design the furnace in the identical or a similarly defective manner. The court stated, "This claim arose from the mutual agreement between the parties regarding the specifically requested purpose and design of the furnace." In other words, IMI specifically told Abbott what it needed and for what purpose the furnace would be used, and IMI's damages were caused by Abbott's contractual breach in failing to design a furnace according to IMI's requested needs and uses. The court concluded that "the claim should be limited to a contract claim because the parties' obligations are defined by the terms of the contract, and not by the larger social policies embodied by the law of torts." As the claim against Abbott was contractual in nature, coverage under Erie's commercial general liability policy was precluded.

The gist of the Superior Court's decision in Abbott is the court will look at the essence of the cause of action advanced, not whether the claims are brought under a theory of negligence, in determining whether there is an "occurrence" sufficient to trigger coverage.

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